

## *Food Retailing in the 21st Century — Riding a Consumer Revolution*

### **Executive Summary**

The business of retailing food is going through dramatic, if not revolutionary, change. The causes are simple and complex, visible and hidden.

- The singular force driving the revolution is the consumer. The consumer’s market power is growing strong and ingrained. Scanning data drive product assortment with the help of business practices such as category management.
- Competition has never been more vigorous with more than a dozen types of retailers vying for market share. Food retailers today include conventional supermarkets, superstores, supercenters, membership clubs, combination (food and drug) stores, natural and organic outlets, limited assortment stores, convenience stores, dot-coms and gasoline stations. Consumers have never had more choice in variety, value, nutrition and quality.
- The competition includes restaurants, especially fast food, which are near the milestone of controlling half the \$1 trillion market for food sales. Dual-income couples and generations X and Y are fueling steady sales growth in “food away from home.”
- Also driving competition is the minimal growth of the U.S. population. Today, food retailers can grow only by taking business away from competitors.
- Rigorous competition helped contain food inflation to a yearly average of 2.5 percent from 1997 to 2006. Moreover, the cost of food continues to decline as a portion of family income — from 50 percent in the 19th century to 9.9 percent today.
- Competition and new management practices have changed pricing strategies. Many retailers no longer use milk as a loss leader, for example, because it doesn’t draw consumers into stores. Shoppers can always find low-cost gallons at the many discount food retailers.
- Farm-to-retail price spreads vary widely and are affected by unpredictable forces such as weather, supply/demand and international trade. There is always a delay when changes in farm costs show up on retail shelves. Price spreads can also be distorted if they are based on the Consumer Price Index, which, experts agree, overstates inflation.

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The Food Marketing Institute (FMI) is a nonprofit association conducting programs in research, education, industry relations and public affairs on behalf of its 1,500 members including their subsidiaries — food retailers and wholesalers — in the United States and around the world. FMI’s U.S. members operate approximately 26,000 retail food stores with a combined annual sales volume of \$340 billion — three-quarters of all retail food store sales in the United States. FMI’s retail membership is composed of large multi-store chains, small regional firms and independent supermarkets. Its international membership includes 200 members from 50 countries.



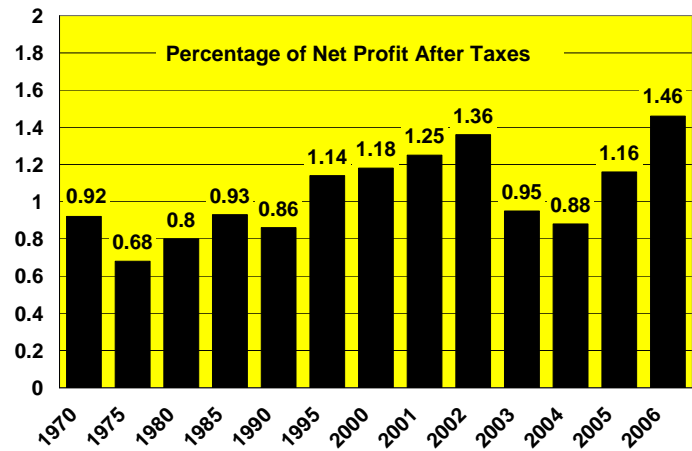
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### The Consumer Dictates Change

It is often said that the balance of market power is shifting to retailers. This is true only to the extent that retailers know the demands of their customers. An old industry truism holds that “the consumer is king.” Food retailers today would update that saying to “the consumer is dictator.” The market power of consumers is strong and growing stronger as a result of fierce competition, new technology and new business practices.

Consumer market power is becoming ingrained through the increased use of scanning data to decide product assortment, prices and marketing strategies. The data could not be more detailed — a record of every single product purchased, showing consumer preferences with precision and speed. Through the fast-spreading practice known as category management, consumer demand is increasingly driving decisions about products and services. The margin of error for failure is as narrow as the industry’s average net profit of one penny on each dollar of sales (see Figure 1).

**Figure 1. Food Retailers Feed America at a Profit Of One Penny on Every Dollar of Sales**



Sources: FMI, Annual Financial Review; Cornell University Operating Results of Food Chains.

### Category Management

Until recently, retail buyers made most product decisions, shopping for the best deals from suppliers. This often resulted in large purchases of individual items that gathered dust in warehouses and shortages of products for which demand unexpectedly increases.

Category management eliminates these problems by placing buying decisions in the hands of executives who keenly monitor consumer demand. Category managers view assortment strategically, evaluating the performance of entire groups of related products, such as soft drinks, baby food, cereal and produce. They do not measure success by sales increases in individual items, which may occur at the expense of other brands of the same items.

Their goal is to maximize sales for the entire category, which requires continually adjusting the assortment to more precisely match consumer demand. They feed scanning data and other information into computer models to make assortment decisions. The results often lead them

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to remove products that are not selling well or to reduce the number of products on the shelf or the number of sizes. Category managers increase the availability of the most popular products. The practice helps retailers identify so-called destination products — items that because of their value, taste or distinctiveness draw more consumers into their stores. Managers aspire to create destination categories as part of a broader strategy to make their supermarkets destination stores.

### **Consolidation and Increased Competition**

An apparent paradox in food retailing today lies in two parallel trends: the industry is consolidating while competition among traditional and new channels is increasing dramatically.

In addition, consolidation is not leading to increased food prices. “Many industry analysts feared that consolidation would create less competitive markets and higher food prices, with less pressure on retailers to develop and improve the quality of goods and services available to consumers,” said Ephraim Leibtag, an economist with USDA’s Economic Research Service.<sup>1</sup> “However, the opposite trend has taken hold. Conventional food retailers now vie with Wal-Mart Supercenters, Costco Warehouse Stores and other alternative retail formats that are increasingly offering a larger array of food products to their cost-sensitive customers.”

Several decades ago, competition could be neatly defined by comparing the market shares of regional chains, mid-sized family grocers and small independent operators. Virtually every retailer is now selling groceries, and more than a dozen formats are competing aggressively:<sup>2</sup>

- **Conventional Supermarket** — carries about 15,000 items, including a full line of groceries, meat and produce, with at least \$2 million in annual sales.
- **Superstore** — larger than a conventional supermarket with at least 25,000 items and more nonfoods, such as general merchandise and health and beauty care (GM/HBC) items.
- **Combination Store** — a superstore and full-line pharmacy with GM/HBC products accounting for at least 15 percent of sales.
- **Super Warehouse Store** — a hybrid warehouse/superstore with 50,000-plus items and the full range of service departments, featuring high-quality perishables and reduced prices.
- **Limited Assortment Store** — a low-price outlet with minimal service and fewer than 2,000 items. It features numerous private label products and is popular among food stamp recipients seeking to stretch their limited dollars.

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<sup>1</sup> “The Outlook for Food Prices in 2003,” February 21, 2003.

<sup>2</sup> This breakdown is based on FMI research and analyses by Willard Bishop Consulting, Ltd., in its *Competitive Edge* newsletter of June 2005.

- **Convenience Store** — traditional outlets offer a small selection of dry groceries, beverages, nonfoods and ready-to-heat and -eat foods. Most are now selling gasoline as well.
- **Other Traditional Outlets** — these include numerous small, family-owned bodegas and retailers, along with upscale and ethnic stores that serve specific demographic niches.
- **Supercenter** — a large food-drug combination store and mass merchandiser. These average more than 170,000 square feet and typically devote up to 40 percent of the store to grocery items, which are often sold at loss-leader prices.
- **Wholesale Club** — a retail/wholesale hybrid that offers consumers and small businesses a limited and economical selection of food and non-food products. These measure about 120,000 square feet; 60–70 percent of the space is devoted to bulk sizes of grocery and GM/HBC items.
- **Drug** — a pharmacy that generates at least 20 percent of its sales from grocery, GM/HBC and seasonal items, often at discounted prices.
- **Mass** — a large store selling primarily hard goods, such as clothing and electronics, but also grocery items.
- **Dollar Stores** — a traditional format that now sells 20–80 percent of groceries and other consumable products at discounted prices.
- **Fresh Organic/Natural** — includes traditional retail outlets that place a strong emphasis on perishables and natural/organic stores.
- **Military** — commissaries run by the Defense Department that resemble conventional supermarkets but are restricted to enlisted or retired military personnel.

*The myriad formats reflect the many-colored mosaic of consumer demand.*

**Figure 2. Grocery Industry Market Share by Format**

Store	2005		2010	
	Number	\$Share <sup>3</sup>	Number	\$Share <sup>3</sup>
Superstore	7,978	19.9%	7,587	17.3%
Food/Drug Combination	5,600	13.6%	5,392	11.5%
Conventional Supermarket	13,719	11.2%	12,622	8.3%
Supercenter <sup>1</sup>	2,456	13.6%	3,461	20.7%
Convenience with gas <sup>2</sup>	111,620	13.8%	118,480	13.3%
Convenience without gas	26,100	2.4%	28,817	2.1%
Wholesale Club	1,076	7.1%	1,213	7.3%
Mass	3,963	5.7%	3,759	5.4%
Drug	19,043	4.8%	21,082	4.5%
Limited Assortment	2,699	1.9%	3,898	3.2%
Super Warehouse	530	1.8%	582	1.7%
Dollar	19,351	1.7%	27,791	2.1%
Fresh, Organic/Natural	787	0.7%	1,081	1.2%
Military	175	0.5%	175	0.5%
Other (Small Grocery)	9,335	1.4%	8,553	1.1%
<b>Total</b>	<b>224,433</b>		<b>244,493</b>	

<sup>1</sup>Includes Kmart, Super Target, Wal-Mart Supercenters, Fred Meyer and Meijer Stores.  
<sup>2</sup>Market share data do not include gasoline sales.  
<sup>3</sup>Percentages do not add up to 100 due to rounding.

Source: Willard Bishop Consulting, Ltd., *The Future of Food Retailing*, July 2006

The listing above includes taxpayer-subsidized military commissaries but not the discount stores owned by native Americans, which together account for about \$5 billion in sales and 1 percent of the U.S. food retail market. Among the “Other” and “Conventional Supermarket” retailers are the increasing number of stores catering to Asian, Hispanic and other groups with specialized cuisines.

The emergence of this many channels shows a highly innovative and competitive industry trying to meet diverse and fast-changing consumer demands. The myriad formats reflect the many-colored mosaic of consumer demand. For one-stop convenience, shoppers can go to superstores, supercenters, combos and super warehouse outlets. For value, they have limited assortment, super warehouse, dollar and wholesale club stores. The spectrum of choices is the broadest ever (see Figure 2).

The slow growth rate of the U.S. population has made competition even more intense. For decades, the annual rate has been 1 percent or less. With minimal growth in the number of people to feed, retailers can grow only by taking business away from competitors.

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**The Bigger Competitive Picture**

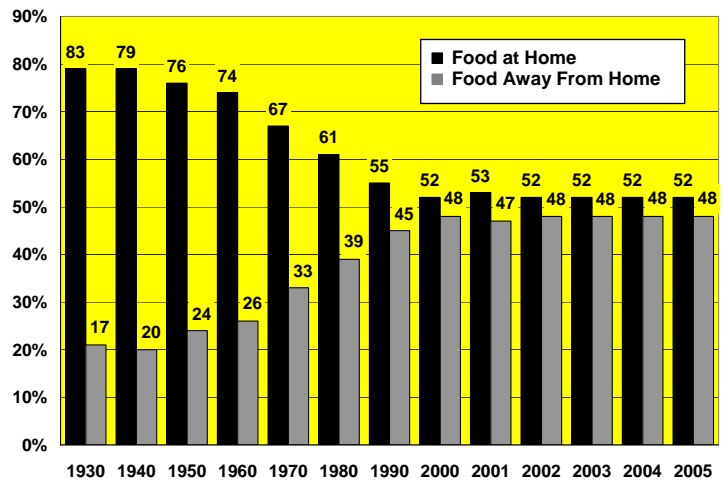
At the turn of the 20th century, Americans bought virtually all their food as ingredients or in raw form to be prepared for meals eaten at home. For decades, restaurants held an insignificant share of the food retailing market. A century later — boosted largely by the growth in fast-food sales — consumers are buying nearly half their food at restaurants and takeout establishments (see Figure 3).

Families still eat most of their main meals at home, but a dramatically increasing number of those meals are fully or partially prepared by outside sources.

Driving this trend is the increase in dual-income families (and their overworked couples), time-starved soccer moms and dads, and young adults who don’t like to cook, don’t know how and don’t care to learn. All these people — many of them members of the baby boom, X and Y generations — share an aversion to preparing meals. As a result, they buy an increasing portion of their food ready-to-eat or -heat.

Many food retailers today —

**Figure 3. The Changing Competitive Dynamics In the Business of Feeding America**



Source: USDA Economic Research Service, “Food CPI, Prices, and Expenditures: Food and Alcoholic Beverages,” Table 1.

Note: Data excludes sales of alcoholic beverages.

especially those with an eye on the future — are entering the foodservice business. They are expanding and upgrading the frozen meal selection. Their bakeries are selling breakfasts. Their delis are selling lunches and side dishes for dinner. Salad, pizza and coffee bars are spreading. Some retailers, notably Wegmans Food Markets, Inc., Ukrop’s Super Markets, Inc., and Harris Teeter, Inc., are flourishing in the market known as meal solutions.

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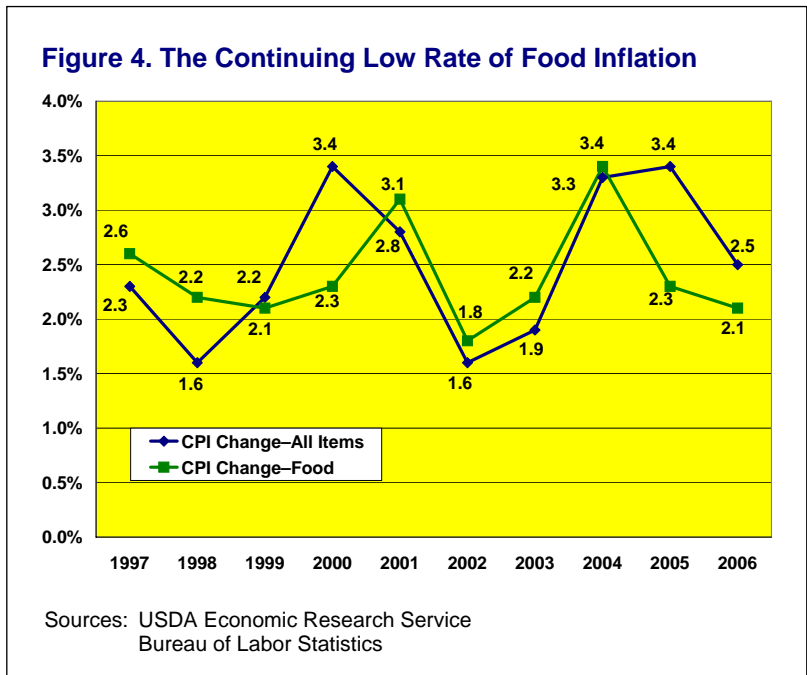
Today, any meaningful competitive analysis of the industry must be based on all food purveyors — retailers and restaurants of every type — an economic arena currently valued at about \$1 trillion.

**The Low Cost of Food**

Food prices have remained remarkably stable (see Figure 4). From 1997-2006, yearly food inflation averaged only 2.5 percent, according to the USDA Economic Research Service and Bureau of Labor Statistics. This figure was only 2.1 percent in 2006 — less than the overall inflation rate of 2.5.

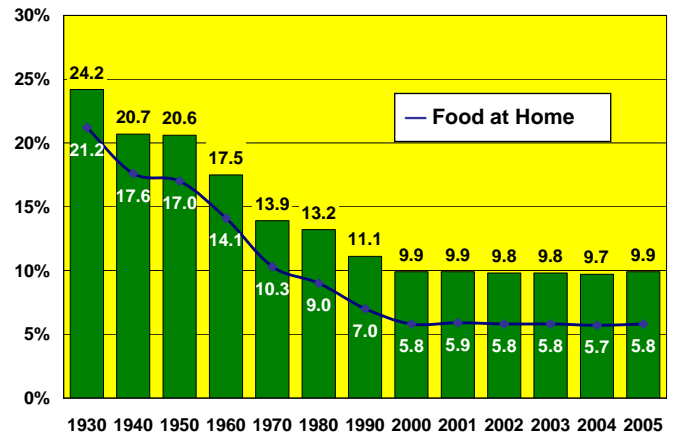
Contributing to the low food inflation rate are increased efficiency and decreased waste; technology; category management; and the many formats — from limited assortment stores to warehouse clubs to supercenters — that use low prices as their main draw for consumers. Even if inflation increases, consumers can always find bargains at these stores.

In addition, many economists now agree that the CPI overstates the inflation rate for food. Among the reasons are that it is based on a limited, fixed market-basket of items, most of which are purchased at conventional supermarkets. It fails to take into account how families stretch their food dollars by buying sale items and bulk sizes, using coupons and loyalty card program discounts, switching from national brands to private label products and purchasing more groceries at low-price outlets.



The flaws in the CPI trigger misunderstandings. For example, in the fourth quarter of 1998, an over-supply forced producers to sell pork products at historically low prices. CPI data suggested that retailers were not passing along the savings to consumers. This finding angered producers, who were hoping that lower retail prices would increase sales and help eliminate the over-supply. When retailers insisted they had lowered prices and were widely featuring pork products in sales, producers turned to another source, Information Resources, Inc. IRI monitors prices by collecting scanner data from more than 10,000 supermarkets on a regular basis and had just started tracking fresh meat. The IRI data showed that retailers dramatically lowered pork prices in the fourth quarter of 1998 and decreased them more in December from November.<sup>3</sup>

**Figure 5. Food as a Percentage of U.S. Family Income**



Source: USDA Economic Research Service, "Food CPI, Prices, and Expenditures: Expenditures as a Share of Disposable Income," Table 7.

Low inflation tells only part of the story. The cost of food as a percentage of family income has declined steadily and significantly over the past century (see Figure 5). In the 1800s, historians estimate that families spent about half of their disposable income on food. Today, the portion has declined to 9.9 percent overall, according to USDA data. The BLS, using a different methodology, reports the cost of food at 13.3 percent of after-tax disposable family income. By contrast, Americans spend 32.1 percent of their income on housing and 18.0 percent on transportation.<sup>4</sup>

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### The Farm-to-Retail Price Spread

For people new to the food industry, some of the most puzzling questions concern the spread between the retail price for products and the income to farmers. Years ago when variety was much smaller and food accounted for a larger portion of family income, the gap was narrower. Food was not processed in large quantities. It was not mass merchandised. Little of it was packaged, much less partially or fully prepared for the consumer's convenience. Produce was not available in the winter months. In addition, the industry did not face the considerable challenge of feeding nearly 300 million people — most of them living great dis-

<sup>3</sup> "Data Show Grocers Lowered Pork Prices in Fourth Quarter," *Feedstuffs*, June 7, 1999, p. 1.

<sup>4</sup> *Consumer Expenditures in 2004*, published in April 2006.



The prices and price spreads for some products can vary widely depending on many factors. The farm value for products such as perishables that are not extensively processed tend to be higher. In addition, the prices of these products can be affected significantly by weather conditions that increase or decrease the supply, and by international trade and fluctuations in foreign currency exchange rates.

There is often a delay before cost changes at the farm are reflected in retail prices. This is because the price of products currently on the shelf are based on what the retailer paid before supply-and-demand factors changed the farm cost. The lag time depends on how long it takes for products to move through the supply chain. In the case of a minimally processed and fast-moving product such as eggs, the lag time may be measured in weeks. For beef, however, months may pass before retailers can put lower-cost cuts on their shelves.

In addition, retail prices tend to change less frequently than farm costs. The prices for some commodities changes daily, while product sales and other practices can lock in retail prices for a week or longer.

Price spreads are also affected by the number of parties in the supply chain for different products. In the case of beef, the product passes through up to four intermediaries before reaching the retailer. Each adds value to the product to make it edible and in a form that consumers desire. The cattle rancher, for example, has a feedlot operator nourish the livestock. At the slaughterhouse, the cattle are killed, and the meat is graded and prepared for processing into consumer cuts. The packer then processes the meat into the cuts and packages it for the retailer. A grocery wholesaler may help bring the product to market as well.

As a result, the price spread reflects the costs incurred by all the parties in the supply chain. The farm-to-retail spread in beef does not reflect what the retailer paid the rancher, rather the costs incurred and the prices charged by all the parties in the beef supply chain.

### **Milk Prices Vary by Format and Category Plan**

Changes in retail pricing practices may also come into play. One example is milk. For many years, retailers used milk as a loss leader to draw consumers into the store. Major changes in the dairy case and in consumer demand have prompted many retailers to abandon this practice. Category analyses show that consumers want a greater variety of dairy products, including soy, whole, skim, 1 percent and 2 percent milk. Demand is also increasing for smaller sizes and for flavors such as chocolate milk.

While the dairy case diversifies, consumer demand for many other types of beverages is increasing sharply. Retailer analyses of the beverage and dairy categories may show that low-priced gallons of milk no

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longer draw consumers into their stores. In today's highly competitive market, consumers wanting low-cost milk can shop at limited assortment stores, warehouse clubs, supercenters and other discount formats that use an every-day-low-price (EDLP) strategy. Conventional supermarkets are using other features and services to draw consumers into their stores.

***Entire Industry Must Ride the Revolution***

All segments of the industry today must look foremost at the needs and demands of consumers. Technology and new management practices have given the industry powerful strategic tools to track demand by neighborhood, by block and even by family. And the fierce competition leaves little margin for error. The companies that survive and flourish will be the ones that learn best how to ride this consumer-driven revolution.